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SUBJECT: CHILE KNOWS IT NEEDS MORE INNOVATION

¶1. SUMMARY. Despite President Bachelet's declaration that innovation would be one of the pillars of her administration, budgets for research and development remain precariously low in Chile -- only seven tenths of one percent of GDP. A ministerial commission tasked with identifying innovative sectors and ways to promote them has drafted legislation for tax breaks it hopes will increase private sector spending on innovation and bring new technology to Chile. END SUMMARY.

¶2. Soon after taking office in March, President Bachelet set up the Council on Competitiveness and Innovation to seek concrete ways to identify and incentivize knowledge-based sectors of the economy. Chile's export-oriented economy remains dependent on primary products -- copper alone represented nearly 50 percent of the value of Chile's exports in 2005. There is very little value added in Chile's economy and this presidential council was tasked with finding ways to change that. It is composed of representatives from five ministries -- Finance, Economy, Education, Agriculture and Public Works -- and is headed by former Finance Minister Nicolas Eyzaguirre.

¶3. Talk of innovation is new for Chile, it began with Bachelet. She has asked the Council on Competitiveness to recommend nine sectors and industries (e.g. biotech), which the GOC will seek to foster. Also to that end, the Council has drafted legislation to encourage greater private sector spending on research and development. Currently, there is almost no private sector spending on innovation. Part of that may be due to Chile's poor track record on protecting intellectual property rights (IPR). GOC officials say they appreciate the interplay between protecting IPR and promoting innovation. Some at least are aware that a lack of a clear GOC policy on IPR protection could be a hindrance. A member of the Council told Senior EconOff he had been unaware of U.S. and EU concerns over IPR protection in Chile. He agreed the GOC lacked a clear policy and said he would seek to have the Council discuss it.

¶4. The Ministry of Finance has the lead in drafting tax legislation and recently presented two proposals to congressional committees. The first is a tax reform intended to incentivize research. Through a 35 percent tax credit and then a 65 percent deduction allowed against the corporate tax rate, the GOC would pick up the tab for about 50 percent of a private company's spending on research and development. Currently, there is virtually no tax incentive for spending on research. The second draft would set the import/withholding tax on software at a uniform 15 percent. A number of taxes are applied against imported software now, with the total hit ranging up to an added 35 percent in costs. The net result has been reluctance on the part of

Chilean companies to buy the tailored software they need.

¶5. Spending on innovation in Chile is abysmally low. An advisor with the Ministry of Finance, who serves on the Council on Competitiveness and Innovation, told Senior EconOff that only seven tenths of one percent of Chile's GDP is spent on research and development. Bachelet's goal is to raise that spending level to 1 percent of GDP by 2010. Even at 1 percent, as Santiago's leading newspaper editorialized November 20, this level would lag far behind countries such as Ireland, Singapore and New Zealand. Worse than current spending levels in the eyes of the Ministry of Finance advisor, of the money currently spent on research and development, two thirds of it is public sector money. Chilean private companies spent only three tenths of one percent of GDP on research in 2005, or about USD 350 million. There is also no evidence that the public sector money spent on innovation led to any economic growth or job creation.

¶6. If the Chilean private sector is not spending enough money on research and development, foreign investors are not spending money on it at all. Though Chile might still be able to attract respectable levels of foreign direct investment (FDI) -- however, the total level in 2005 showed a big drop-off compared to 2004 -- most of the FDI goes to a few basic sectors. Over 80 percent of the investment that has entered Chile in 2006 has gone to the mining, water, gas and electricity sectors. Moreover, much of that FDI has gone into mergers and acquisitions, not into creating new infrastructure or jobs.

¶7. COMMENT. To its credit, the Bachelet administration has realized it must develop concrete incentives to get companies to spend on research and development. Putting the onus of identifying promising industrial clusters on a ministerial commission smacks of state interventionism, but it is at least an effort to determine where Chile's might be able to develop a comparative advantage. If Chile really wants to overcome its reliance on primary product exports and more importantly, update its conservative business culture, it will likely have to do more than tinker with tax rate margins. It will need to articulate publicly a clear policy direction on innovation, including IPR, and stick to it over the long term.
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